#2570 **signed 1-29-02**

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS

In re: **MARK WALLACE SMITH,** **NOEL ETOLA SMITH,** **DEBTORS.**	**CASE NO. 99-41536-13** **CHAPTER 13**
In re: **MARK ALLEN GUY,** **RHONDA LYNN GUY,** **DEBTORS.**	**CASE NO. 99-41945-13** **CHAPTER 13**
In re: **ALEXANDER JOSEPH DeYOUNG,** **HEATHER LYNN DeYOUNG,** **DEBTORS.**	**CASE NO. 99-42272-13** **CHAPTER 13**
In re: **GINA LEANN LEAK,** **WAYNE EDWARD LEAK,** **DEBTORS.**	**CASE NO. 99-42481-13** **CHAPTER 13**

ORDER DETERMINING MARKET RATES OF INTEREST REQUIRED BY §1325(a)(5)(B)(ii) TO BE PAID ON CLAIMS SECURED BY VEHICLES

These matters are before the Court for resolution following an evidentiary hearing held on July 16 and 17, 2001, on the objections of creditor Household Automotive Finance Corporation ("HAFC") to the interest rates the debtors had proposed to pay on its secured claims under their chapter 13 plans. HAFC appeared by counsel Susan A. Berson of Shook, Hardy & Bacon L.L.P. of Kansas City, Missouri. The standing chapter 13 trustee, Jan Hamilton ("Trustee"), appeared *pro se*. The DeYoungs and the Leaks appeared by counsel Michael F. Brunton of Topeka, Kansas. The Guys appeared by counsel Jill Michaux of Neis & Michaux of Topeka, Kansas. The Smiths appeared by counsel Robert Green of Ottawa, Kansas. The parties have submitted post-trial briefs and replies and the matter is now ready for decision.

As specified in an order issued by the Court on June 4, 2001, the sole issue of law to be decided in these matters is the following:

> When debtors propose in a chapter 13 plan, as permitted by 11 U.S.C.A. §1322(b)(2), to modify the rights of a creditor holding a claim secured by a vehicle, what is the appropriate market rate of interest they must propose to pay on the claim to satisfy the requirements of §1325(a)(5)(B)(ii)?

At trial, the parties presented evidence they thought would establish the market rate of interest that this Court must determine as required by the Tenth Circuit's decision in *Hardzog v. Federal Land Bank (In re Hardzog)*, 901 F.2d 858 (10th Cir. 1990).

FACTS

HAFC loans money to consumers for the purchase of automobiles, identifying itself as "an indirect sub-prime automotive lender." By "indirect," HAFC means that it does not have direct contact with the consumers, but makes its loans through car dealers. By "sub-prime," HAFC means that it makes loans only to consumers that it considers to be high-risk borrowers. Sometime before they filed for bankruptcy, one or both of the debtors in each of these cases submitted a loan application to HAFC through a car dealer. Although the applications used for the debtors were not uniform, they all asked for the debtors' names, addresses, and salaries, information that all the debtors supplied. The vehicles the debtors were purchasing and the amounts they wanted to finance either appeared on the applications or were otherwise furnished to HAFC by the dealer.

The application form the Smiths completed asked for their monthly house or rent payment, the balance due on the last car they had financed, and the name, address, and account number of "credit references or instalment obligations." The Smiths supplied only their monthly house payment. HAFC gave them the loan in September 1998. The Smiths filed their chapter 13 bankruptcy petition in July 1999.

The application form the Guys completed asked for their monthly house or rent payment, and the balance due on the last car they had financed, both of which they supplied, but the form did not seek any other information about their debts. HAFC gave them the loan in March 1999. The Guys filed their chapter 13 bankruptcy petition in August 1999.

Mr. DeYoung alone obtained the loan involved in the DeYoungs' case, and Mr. Leak alone obtained the loan involved in the Leaks' case. The application forms they filled out are very similar and both contain the following areas to be completed: (1) boxes for monthly house or rent payment and the amount owed on any mortgage; (2) boxes for "credit references," including the name of the creditor followed by boxes labeled "open," "closed," "date open," "high," "term," "payments," and "balance(s)"; (3) a box labeled "prev. car financed or leased with"; and (4) a small area labeled "Debts: List all debts including alimony, child support, separate maintenance," followed by a small box with a dollar sign and "per mo." printed in it, and a somewhat larger box with "Debts:" printed in it.

Mr. DeYoung filled in a monthly rent amount, the names of two creditors in the credit references area but no other information about them, and the name of a creditor with whom he had previously financed or leased a car. Otherwise, he left the four areas described above blank. HAFC gave him the loan in January 1999. The DeYoungs filed their chapter 13 bankruptcy petition in October 1999.

Mr. Leak provided a mortgage balance amount, and the name of one creditor with the "closed" box after it checked, but otherwise left the four areas described above blank. HAFC gave him the loan in March 1999. The Leaks filed their chapter 13 bankruptcy petition in November 1999.

Besides the application forms the debtors completed, HAFC obtained and used credit reports along with an unexplained internal scoring method to determine whether to make the loans and what interest rates to charge. As indicated, although none of the debtors provided detailed information about their monthly expenses, whether the application asked them to or not, HAFC gave them the loans they used to purchase the vehicles. The interest rates it charged them ranged from 15.3% to 20.95%.

In three of the cases, the debtors filed chapter 13 plans proposing to pay HAFC the value of its collateral plus the discount interest rate established as of the date they filed for bankruptcy under a formula ("the Agreed Formula") previously agreed to in litigation before this Court some years ago. For the Smiths, the rate was 8.16 percent, for the DeYoungs, it was 8.29 percent, and for the Leaks, it was 8.41 percent. The Guys' plan also proposed to pay HAFC the value of its collateral, but did not mention interest; in practice before this Court, such a plan is understood to propose paying interest under the Agreed Formula. For them, the rate was 8.22 percent. In all four cases, HAFC objected to the proposed interest rate, and asserted that its contract rates were more appropriate for these debtors. The plans were confirmed, reserving the question whether HAFC is entitled to the extra interest. If it is, the debtors will probably have to extend the length of their plans in order to pay the additional interest.

At trial, HAFC sought to establish the interest rates it should be paid through the testimony of Joe Batista and Rodney Widner. Mr. Batista is a regional sales manager for Primus Financial ("Primus"), a division of Ford Motor Credit. Mr. Widner is a unit manager in HAFC's bankruptcy department.

The Court summarizes and critiques Mr. Batista's testimony as follows. Primus makes indirect auto loans to all kinds of consumers, and is not strictly a "sub-prime" lender as HAFC is. Mr. Batista explained how he determined the rate of interest that he believed the market would have charged the debtors on a car loan they might have obtained at the time they filed for bankruptcy. To do so, he reviewed all the debtors' original loan applications, the credit reports HAFC had obtained before making the loans, and new credit reports issued near the time the debtors filed for bankruptcy. He is aware that Primus has a credit scoring method it uses in deciding whether to make loans and, while he does not know all the factors the method incorporates, he believes it is heavily weighted toward the applicant's credit history, with consideration also being given to the loan amount compared to the value of the collateral (here, the vehicles being purchased). If the applicant owes any judgments or other claims that have been turned over to collection agents, as the debtors in these cases did, Primus considers him or her to be a higher risk borrower and so charges a higher interest rate. Based on these considerations and an interest rate sheet that Primus uses, he concluded that the current interest rates Primus would charge these debtors would be between 18 and 21 percent. In arriving at this opinion, Mr. Batista did not review the debtors' bankruptcy schedules, and was not asked to look at, and so did not consider, the income and expenses they reported on their schedules, either. He did not look at their chapter 13 plans, or consider the effects the plans would have on the debtors' financial conditions.

Instead, he assumed their financial conditions remained the same after they filed for bankruptcy as they had been before.

Mr. Batista further suggested that the rate of interest that would be paid to HAFC under the Agreed Formula is less than Primus has to pay to obtain money to loan, that is, its "cost of funds." However, he admitted that he is not responsible for borrowing money for Primus, and ultimately conceded that some of the interest rates shown on Primus's rate sheets that he was using were lower than the rates that would be paid to HAFC under the Agreed Formula. He pointed out that the higher rates on the rate sheet generate the most profits, but agreed that none of the rates is intended to lose money for Primus. His claim that the interest rate set by the Agreed Formula is less than Primus's cost of funds conflicts with his concession that Primus's rate sheet does not include any rate that would cause it to lose money. Of course, Primus is in business to make money, and the Court resolves the conflict in Mr. Batista's testimony in favor of Primus's profit motive. Consequently, the Court finds that the interest rate set by the Agreed Formula is not less than Primus's cost of funds.

The Court summarizes Mr. Widner's testimony as follows. Mr. Widner is in charge of monitoring HAFC's loans after the borrowers have filed bankruptcy cases in the District of Kansas. He has never been a loan officer for HAFC, and is not familiar with all the criteria HAFC uses in its lending process. He made some comments about HAFC's cost of funds, but they were not based on his personal knowledge and were not convincing. Mr. Widner claims that it costs HAFC more to monitor loans in bankruptcy than to monitor its other loans. He believes that the high interest rates HAFC charges borrowers like the ones in these cases do not cover the costs of HAFC's 30-member bankruptcy department, costs that include monitoring to see that the debtors make their payments and maintain insurance on HAFC's collateral, dealing with debtors' counsel and case trustees, revising HAFC's computer data regarding collection of these accounts to insure that HAFC does not violate the automatic stay, and handling any other matters that may arise in bankruptcy cases. Although he does not participate in HAFC's loan-making process, Mr. Widner asserted that if the company were making new loans to the debtors now, it would charge the DeYoungs 16.25 percent interest and the rest of the debtors 20.95 percent. These rates would be based, at least in part, on the debtors' credit histories, but would not take into account the debtors' cash flows while they remain in chapter 13 or the fact that the automatic stay restricts all their creditors' abilities to enforce judgments and pursue other collection activities.

The Court finds that Mr. Widner's assertion that the administrative costs of his department are not included in HAFC's calculation of interest rates to charge borrowers is highly suspect. His remarks appear to have been based on office scuttlebutt rather than any personal knowledge. More significantly, though, it is simply unreasonable to think that a "sub-prime" lender like HAFC—that is, one specializing in making high-risk loans—does not consider the additional collection costs such loans are likely to entail, including any caused by bankruptcy filings, when it determines the interest rates to charge its customers. The Court is convinced that HAFC must monitor its borrowers' payments and insurance coverage even when they have not filed for bankruptcy. In fact, the required monitoring should be less difficult for borrowers who have filed chapter 13 bankruptcies than those who have not because HAFC's contacts will be with the chapter 13 trustee or with counsel for the debtor, either of whom are likely to be easier to reach and have more accurate records than the bankrupt borrowers. The Court believes that HAFC must factor these costs into the interest rates it initially decides to charge. If HAFC has not taken them into account for borrowers who wind up filing for bankruptcy, it must not have considered them for those who do not, either. Some limited costs would be caused solely by the borrowers' bankruptcy filings, such as transferring responsibility for the loans to the bankruptcy section, changing HAFC's computer data to prevent dunning letters or telephone calls that would violate the automatic stay, reviewing the debtors' proposed chapter 13 plans, and filing proofs of claim. However, monitoring the debtors' payments, insurance, defaults, and so forth should be no more difficult than it would be for any other borrowers.

The trustee and the debtors called six witnesses. William Griffin was the chapter 13 trustee for the Topeka and Kansas City, Kansas, divisions of the U.S. Bankruptcy Court for the District of Kansas from 1990 until 1998, when the caseload was split between the divisions, and he remained the trustee for Kansas City only. He explained how the interest rates paid to secured creditors changed during his tenure. When he first became the trustee for both divisions, the interest rate (for Topeka, at least) was established as equal to the latest coupon issue yield equivalent of the average accepted auction price for the last auction of 52-week Treasury bills, which, at the time, were held every four weeks ("the T-bill Rate"), plus a 2 percent risk enhancement.[1] Then in 1990, the Tenth Circuit ruled in

---

[1]To understand how the Court arrived at this formula (but with a 1 percent risk factor that the Court later increased to 2 percent), see *In re Fisher*, 29 B.R. 542 (Bankr.D.Kan. 1983); *In re Redeker*, 27 B.R. 734 (Bankr.D.Kan.1983); and *In re Jewell*, 25 B.R. 44 (Bankr.D.Kan. 1982). However, the last auction of 52-week T-bills on the regular four-week schedule was held on March 3, 2000, *see* document on the Federal Reserve Board's Internet Web site at "http://www.federalreserve.gov/releases/H15/data/wf/tbaa1y.txt" (released Jan. 22, 2002) for a listing of the interest rates obtained in auctions of 52-week T-bills from April 1959 to June 2, 2000, and those auctions now occur only at irregular intervals, *see, e.g.*, documents at "http://www.publicdebt.treas.gov/of/ofrespr.htm", indicating 52-week T-bills were issued during 2000 on January 6, February 3, March 2, June 1, August 31, and November 30 for auctions apparently held

Hardzog, 901 F 2d. 858, that §1225(a)(5)(B)(ii) of the Bankruptcy Code requires a family farmer's reorganization plan to pay secured creditors a market rate of interest for similar loans in the region to provide them with the present value of their claims. General Motors Acceptance Corporation and several credit unions then objected to the interest rate formula that was being applied in cases before this Court. In 1992, their objections were resolved by the parties' agreement that the risk factor would be increased by one percent. From then until sometime in 2000, the interest rate continued to be the most recent T-bill Rate on the date the chapter 13 case was filed plus three percent (the Agreed Formula mentioned earlier), and no creditor had complained until HAFC filed its objections in these cases. Mr. Griffin explained that having a known interest rate for all claims is necessary for him to be able to determine whether debtors' plans are feasible by the time they first come before the Court for a confirmation hearing. Claims are not always filed before confirmation, so other rates creditors may wish to be paid will not always be available in time for confirmation.

Tim Owens, a CPA in the Topeka Trustee's office, testified that from the Trustee's perspective, the Agreed Formula made it easier to administer the cases. The Agreed Formula also made it easy for debtors, creditors, and counsel to ascertain the current rate because the current T-bill Rate was widely published and available. However, the Trustee can and does use a different rate when a debtor requests it to protect a co-signor on a debt. Mr. Owens added that there might have been

---

the day after the issue dates. During 2001, they were issued only on March 1. Since this change occurred, the Court has not been asked formally to specify a new benchmark for the riskless rate to use in the Agreed Formula, nor have parties appearing before the Court agreed to a new one. Apparently, the trustee has continued to use a rate around 9 percent since the regular four-week auctions ceased, and no one has objected to it.

other, less frequent situations where an exception to the Agreed Formula was also made.

The other four witness called by the Trustee and the debtors were officers of local lending institutions. Each institution currently has a number of debtors repaying automobile loans through chapter 13 plans in this district. None of the lenders limits itself to “sub-prime” lending, although each makes loans to people who would qualify for such lending from HAFC. These lenders all, to some extent, base their interest rates on competition, internal goals, asset liability management, cost of funds, and overhead, along with loan applicants’ debt-to-income ratios, credit reports, time on the job, residence, and perceived ability to pay. The Court summarizes their testimony as follows.

Ken Farley is the credit control officer and a loan officer at the Super Chief Credit Union in Topeka, Kansas. He explained how the credit union handles car loans. It makes such loans directly to consumers, rather than through car dealers, and classifies its loans as “open end” or “closed end.” An “open end” loan allows reborrowing as the loan is paid down. A “closed end” loan is a traditional term loan. In deciding whether to make car loans, the credit union does not penalize borrowers for their credit history, but instead tries only to determine whether they can make the scheduled loan payments. If the loan is approved, the interest rate charged is based on the age of the vehicle and the term of the loan, not the borrowers’ credit history. Its auto loans generally have 60-month terms. At the time of trial, its closed-end rates for 60-month loans ranged from 7.75 percent for 2000 and 2001 vehicles to 11 percent for 1993 and older vehicles. In February 1997, according to an attachment to its proof of claim, the credit union made a loan to the Leaks that was secured by an automobile, charging them 7.99 percent interest. Sheets showing the credit union’s interest rates for car loans as of January 1, 2000, April 1, 2000, and July 1, 2000, were also introduced at trial.

Michael Cast is the consumer lending manager and consumer compliance manager for Capitol Federal Savings and Loan. Capitol Federal is a publicly traded company with $8 billion in assets. Like the credit union, it is a direct lender, and makes 60-month loans on new cars and 48-month loans on used ones. At the time of trial, its interest rate for 60-month new car loans, up to a maximum of $35,000, was 8.74 percent. Its rate for used vehicles, up to a maximum loan of $25,000, ranged from 8.5 percent for 48 months on a one-year-old vehicle to 9.5 percent for 36 months on 1994 to 1997 vehicles. Sheets showing Capitol Federal's interest rates for car loans as of various dates from November 1998 to June 2001 were also introduced at trial.

William T. Nichols is the senior vice president and chief credit officer for Commerce Bank and Trust of Topeka, Kansas. He supervises all lending functions for Commerce, which makes both direct and indirect loans. At the time of trial, its 60-month interest rate for direct loans on new vehicles was 7.5 percent. Its direct rate for used vehicles ranged from 7.5 percent for 54 months on 1999 or newer vehicles to 11 percent for 30 months on 1994 vehicles.

Allan Towle is the executive vice president of Fidelity State Bank and Trust of Topeka, Kansas. He supervises all lending functions for Fidelity, which also makes both direct and indirect loans. At the time of trial, its 60-month interest rate for loans on new vehicles was 7.99 percent. Its direct rate for used vehicles ranged from 8.25 percent for 60 months on 1999 or newer vehicles to 10 percent for 24 months on 1994 or older vehicles. Sheets showing Fidelity's interest rates for direct and indirect car loans as of February 2000, April 2000 (indirect only), June 2000, and April 2001 were also introduced at trial.

. Besides testifying about the interest rates charged by their institutions, each of these witnesses also stated that he was familiar with interest rates generally charged in the Topeka area for auto loans. Each of them testified that an interest rate based on the published T-bill Rate plus an upward adjustment of 300 basis points, or 3 percent (in other words, based on the Agreed Formula): (1) was a fair rate for creditors to receive and debtors to pay; (2) was easy to determine by checking sources readily available to the public; (3) provided stability; and (4) saved time and money that might otherwise have been spent litigating about the proper rate. The witnesses submitted interest rate schedules used by their institutions showing that, in general, the interest rates established under the Agreed Formula fell within the parameters of the interest rates they were charging. Though each of their institutions has some rules it applies to lending decisions, they all leave some room for assessments of the particular prospective borrowers. HAFC, by contrast, relies strictly on fixed rules and makes no attempt to evaluate prospective borrowers on an individual basis.

Besides the current interest rates the witnesses testified about at trial, the Court has reviewed the historical rates supplied in the exhibits and compared them (to the extent possible) to the rates set for the same time periods by the Agreed Formula. The Court finds that the Agreed Formula rate usually fell within the range of rates available from the institutions whose rates were supplied (typically toward the upper end of the range), and never fell more than one-half of one percent outside the range. Even though it is no longer being adjusted because the regular auctions of 52-week T-bills are no longer occurring, the rate the trustee was using at the time of trial still fell comfortably within the range of rates that Super Chief, Capitol Federal, Commerce, and Fidelity were then charging.

DISCUSSION AND CONCLUSIONS

1. Introduction

The parties' dispute in these cases concerns the following portion of §1325(a) of the Bankruptcy Code:

> Except as provided in subsection (b), the court shall confirm a plan if—
> . . . .
> (5) with respect to each allowed secured claim provided for by the plan—
>
> > . . . .
> > (B) . . . (ii) the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim.

11 U.S.C.A. §1325(a)(5)(B)(ii). The phrase "the value, as of the effective date of the plan" means that when a chapter 13 debtor is going to pay a secured creditor over time, the "present value" of the future payments must be at least as much as the allowed amount of the creditor's claim. *See Hardzog*, 901 F.2d at 859 & n. 6 (indicating identical language in §1225(a)(5)(B)(ii) requires present value calculation, and noting §1325(a)(5)(B)(ii) does as well). The concept of "present value" merely recognizes the financial reality that the receipt of $1 today is worth slightly more than the receipt of $1 tomorrow or the next day, and significantly more than the receipt of $1 some years in the future. *See In re Fisher*, 29 B.R. at 543. The generally accepted way to satisfy the present value requirement of §1325(a)(5)(B)(ii) is to determine the allowed amount of the secured claim and add post-confirmation interest to the claim at an appropriate interest rate (often called a "discount rate"), and require that the debtor pay at least that much to the creditor through his or her plan. *See* 2 Keith M. Lundin, *Chapter 13 Bankruptcy* §111.1 at 111-1 (3d ed. 2000). In economic theory, if not always in legal circles, a discount rate is comprised of a riskless rate of interest plus an additional measure of interest to compensate for the risk of the transaction. *See General Motors Acceptance Corp. v. Willis (In re Willis)*, 6 B.R. 555, 559-

65 (Bankr. N.D. Ill. 1982); *Fisher*, 29 B.R. at 543; *see generally* J. Weston & E. Brigham, *Managerial Finance* 244-71 (6th ed. 1978): R. Higgins, *Financial Management Theory and Application* 51 (1977); E. Grant and W. Ireson, *Principles of Engineering Economy* 35-40 (4th ed. 1964).

2. The Tenth Circuit's Hardzog Decision

(a) What Hardzog Said

In *Hardzog*, the Tenth Circuit ruled that, at least in chapter 12 cases, courts making a present value calculation "should use the current market rate of interest used for similar loans in the region." 901 F.2d at 860. The Circuit went on to say:

> Bankruptcy Courts, counsel, lenders, and borrowers should have a familiarity with current interest rates on like-type loans and when a dispute arises, the market rate should be easily susceptible of determination by means of a hearing where each party is given the opportunity to submit evidence concerning the current market rate of interest for similar loans in the region. We are persuaded to adopt this approach by two additional factors. Chapter 12 is predicated upon the theory that the lender is making a new loan to the debtor. It therefore follows that the most appropriate interest rate is the current market rate for similar loans made in the region at the time the new loan is made. This approach should also tend to assure that both the lender and the debtor are treated fairly with neither receiving an advantage over the other.

Id. This language seems to suggest that the relevant interest rate would be some kind of published standard that is readily available to the general public for loans secured by the type of collateral at issue. To this Court at least, the language negates HAFC's argument that its own rates establish the "market rate" that must be applied.

The Court is uncertain about the significance of the assertion, not supported by a citation to any authority, that "Chapter 12 is predicated upon the theory that the lender is making a new loan to the debtor." Where a chapter 12 debtor is using a secured creditor's cash collateral, such as the proceeds of a crop, to pay for the costs of producing new collateral, such as a new crop, the process is similar to the making of a new loan. Here, however, the car loans were made some time ago, and no pot of cash is immediately available to either HAFC or the debtors. As in most chapter 13 cases, the cars are worth something less than the debtors owe to HAFC, and the debtors are paying HAFC the cars' values through their plans, leaving it with unsecured claims for the balance of their debts to it. Often, this facet of chapter 13 gives debtors a last chance to save their cars before the cars are repossessed.

(b) Some Things Hardzog Did Not Say

Nothing in *Hardzog* specifies what the Circuit meant by "similar loans," identifies any particular source or authority that would supply a current market rate, or specifies where the rate will be found. The Court finds it difficult to determine how *Hardzog*'s ruling should be applied to the variety of situations where the Bankruptcy Code requires reorganization plans to pay creditors a "value, as of the effective date of the plan." The "market rate" concept might seem simple enough for a debt secured by real property worth more than the debt, as the Circuit faced in *Hardzog*, but even this situation involves variables the Circuit did not mention. For example, was the real property crop land or pasture land, or some combination of the two? Did it include the debtors' homestead? Was it only their homestead, with no crop or pasture land included? Was it urban, suburban, or rural property? In the Court's experience, these variables can all impact the interest rate a marketplace lender would charge for a loan.

Would the Circuit's analysis have changed if the property had not been worth more than the debt it secured? In that situation, the "new loan" the creditor would be making would be for the full value of its collateral. In the chapter 11 context, where §1129(b)(2)(A)(i)(II) imposes a present value requirement similar to that in §1325(a)(5)(B)(ii), this Court has always been told that no lender in the marketplace will make a loan for 100 percent of the value of real property securing a loan, making the proper determination of a "market rate" in such situations less than clear. *See In re Overland Park Merchandise Mart Partnership,* 167 B.R. 647, 656 (Bankr.D.Kan. 1994). Like the cars involved in these cases, personal property that serves as collateral is almost always worth less than the amount owed on the debt, so the problem of having no market for loans for 100 percent of the collateral's value will frequently arise in any of the reorganization chapters when the debtors have encumbered personal property. The Court has seldom, if ever, encountered lenders who are willing to make loans for the full value of personal property.[2]

Furthermore, while *Hardzog* involved a creditor that voluntarily extended credit to the debtor, making the Circuit's assertion that "Chapter 12 is predicated upon the theory that the lender is making a new loan to the debtor" seem somewhat plausible, the theory seems less appropriate when involuntary secured creditors, such as taxing authorities or personal injury judgment lien creditors, are involved. Yet, §1225(a)(5)(B)(ii), and the similar provisions in chapters 11 and 13, apply to these secured creditors as well.

Finally, although the potential universe of secured creditors is, by and large and especially in any one case, rather limited, somewhat confining the number of interest rate decisions that must be made

---

[2]In the Court's view, the frequently-advertised personal property sales with terms of nothing down and some number of months to pay are not really loans for 100 percent of the value of the property. Instead, the loan-to-value ratio as well as the interest being charged in the transaction are hidden in the difference between the wholesale cost the seller paid for the property and the retail price the buyer is paying for it.

under *Hardzog*'s factual situation, the universe of unsecured creditors is virtually unlimited, and in chapters 12 and 13, debtors must pay all of them at least as much "value, as of the effective date of the plan" as they would receive in a chapter 7 liquidation (commonly called the "best-interests-of-creditors" test). *See* §1225(a)(4) & §1325(a)(4). *Hardzog* seems to suggest that each different type of unsecured creditor—running the gamut from relatives to medical providers to credit card issuers to tort victims to taxing authorities—could argue that their type of debt (their "similar loan") is covered by a different "market rate" of interest. In the District of Kansas at least, since only a few chapter 12 cases are filed each year, such a system of nearly-unlimited interest rate litigation possibilities might be workable in chapter 12, but it would be impossibly unwieldy in chapter 13, since over 2,000 of those cases are being filed here annually. Nationwide, chapter 13 case filings have risen from about 207,000 in fiscal year 1990 to over 380,000 in fiscal year 2000; litigation over interest rates in so many cases could be nearly endless under the *Hardzog* approach.

(c) It Could Be Worse: Something Hardzog Does Not Mean

Fortunately, *Hardzog* seems to reject an even worse result that some courts have adopted. *See, e.g., General Motors Acceptance Corp. v. Jones*, 999 F.2d 63 (3d Cir. 1993); *United Carolina Bank v. Hall*, 993 F.2d 1126 (4th Cir. 1993). They read §1325(a)(5)(B)(ii) to mean that each secured creditor is entitled to interest at its own current rate for making similar loans in the marketplace. As stated in Judge Lundin's treatise: "[I]dentical language appears in the best-interests-of-creditors test in §1325(a)(4). If 'value as of the effective date' means the rate of interest that a specific creditor could realize in the marketplace for a similar loan, then every unsecured claim holder is entitled to an individualized (different) interest rate when a Chapter 13 debtor must pay interest to unsecured claim holders to satisfy the best-interests-of-creditors test." 2 *Chapter 13 Bankruptcy* §112.1 at 112-8. This system would be even more burdensome than the *Hardzog* approach.

(d) Another Troubling Thing that Hardzog Seems to Mean

Hardzog seems to indicate that debtors might be required to pay varying interest rates to different creditors in the same case. A significant problem this raises is made apparent by considering the result if the debtors succeed in making all the payments called for by their plan. If over the life of a chapter 13 plan, one creditor that has an allowed secured claim of $1,000 is paid $1,500 and a second creditor that has an allowed secured claim of $1,000 is paid only $1,250, how can both be said to have been paid the "value, as of the effective date of the plan" of their allowed secured claims? Yet, because the "market rate" for car loans, for example, is typically higher than the "market rate" for home loans, that is exactly what *Hardzog* seems to require. The Court cannot believe that Congress thought it was mandating such a result when it adopted the language of §1225(a)(5)(B)(ii) and §1325(a)(5)(B)(ii) (and all the other Code provisions establishing a present value requirement).

If, to satisfy §1325(a)(5)(B)(ii), the debtors can be required to pay 20 percent interest to one creditor and 10 percent to another, then when they have completed their plan, either the first creditor will have been paid more than the present value of its claim or the other will have been paid less than the present value of its claim. If the first creditor has been paid too much, then the excess has been unfairly taken from the unsecured creditors. If the second creditor has not been paid the present value of its claim, then the plan did not satisfy the requirement that the creditor be paid the "value, as of the effective date of the plan" of its collateral. Although this problem is apparently not discussed in the legislative history of chapter 12 or 13, it is mentioned in the history of chapter 11, where Congress indicated that the present value requirement not only sets a minimum amount that a secured creditor must be paid, but also implies a maximum amount, namely that the creditor may not be paid more than 100 percent of its claim if there are any junior creditors or interest holders who are not being paid in full. *See Merchandise Mart*, 167 B.R. at 657; §1129(b)(2)(A)(i)(II); H.R. Rep. No. 595, 95th Cong., 1st Sess. 413-18 (1977), *reprinted in* 1978 U.S.C.C.A.N. 6369-74.

(e) A Different Kind of Market?

Perhaps not surprisingly, given *Hardzog*'s assertion that the theory of chapter 12 is that creditors are making new loans to the debtors, the parties have presented evidence in these cases concerning only the interest rates that lenders are charging in the market for new loans for cars. But the fact is that no new loans are being made in these or any chapter 13 cases. Instead, the secured amounts that debtors must pay for their cars are typically reduced from those fixed by the parties' contracts to the value of the cars when they file for bankruptcy, and the interest rates they must pay are frequently reduced as well. Their chapter 13 plans are approved by the Court and their performance under their plans is supervised by a trustee. These circumstances indicate that the treatment of secured loans in chapter 13 is more similar to workout arrangements, where lenders make concessions to improve the debtors' chances of repaying them, than to new loans. Indeed, *Hardzog* itself involved no cash collateral but simply a loan secured by real property, and so also strikes this Court as constituting a workout, rather than a new loan, situation. *See In re Stratford Assocs. Ltd. Partnership*, 145 B.R. 689, 701-03 (Bankr.D.Kan. 1992) (in chapter 11 bankruptcy, *Hardzog*'s market rate is not that for new loans, but that for similar workout situations). The Court does not believe that the reasoning of *Hardzog* necessarily precludes parties from presenting evidence of the current "market rate" of interest established in similar workout arrangements in the region. Because workout arrangements probably lead to lower interest rates than are generally available for new loans, the use of workout interest rates would make it possible for more debtors to keep their cars and other encumbered property through chapter 13 plans, thus furthering the general bankruptcy goal of favoring reorganization over liquidation.

3. Rejecting HAFC's Extra Bankruptcy Costs Justification for Higher Interest Rates

HAFC claims it has incurred additional costs as a result of bankruptcy because it has been forced to set up a special department to handle the loans of borrowers who have filed for bankruptcy. However, HAFC undoubtedly monitors all its loans, probably more closely than lenders who do not specialize in making "sub-prime" loans, and must have determined that it saves money by having a separate bankruptcy department rather than training all its monitoring staff how to handle those loans that become involved in the bankruptcy process. The main things its bankruptcy department would have to do for chapter 13 cases that its regular monitoring department would not are to adjust its collection system so that no dunning letters, phone calls, or other contacts with the debtors will be made while the automatic stay is in effect, and to review the debtors' plans and decide whether to object to the proposed treatment of HAFC's claim. Any contacts that its bankruptcy department might be required to make would be with the trustee or debtors' counsel, parties who are presumably easier to contact, more receptive to contacts, and more informative than the debtors would be. Otherwise, the bankruptcy department staff should merely monitor the progress of payments and maintenance of insurance much the same as HAFC's other staff monitors loans that are not in bankruptcy. When chapter 13 debtors commit payment or insurance defaults, HAFC would have to obtain stay relief but otherwise could engage the normal forcible collection process it uses when borrowers who are not in bankruptcy default. After transferring monitoring responsibilities to the bankruptcy department, HAFC's other staff would have time to monitor additional non-bankruptcy files. So, HAFC's bankruptcy department would not seem to duplicate the expense of its regular monitoring staff, but largely substitute for it, once a loan file has been transferred to it.

4. Determining the "Market Rate for Similar Loans in the Region" Based on the Evidence Presented

Despite misgivings about *Hardzog*, the Court must attempt to determine the "market rates" of interest that these debtors must pay to HAFC. One thing that *Hardzog* makes clear to the Court is that an appropriate "market rate" will not ordinarily, if ever, be the rates a single lender might show that it would charge the debtors. Instead, the "market rate for similar loans" must be based on a consideration of the rates charged by a variety of lending institutions.

In these cases, HAFC's witnesses did not convince the Court that the very high interest rates they advocated are appropriate market rates to require these chapter 13 debtors to pay. The witnesses simply ignored the fact that the debtors' plans will reduce their debts to levels that they can afford to pay and prevent creditors from pursuing forcible collection actions against them, making them better credit risks than they were before they sought bankruptcy protection. HAFC did not question the feasibility of the debtors' plans, and the plans have been confirmed, meaning the debtors have shown that they are able to pay as proposed in their plans. Because the debtors have established through the confirmation process that they will be able to make the proposed payments, and they will retain bankruptcy protection and obtain bankruptcy relief only so long as they do pay, there is no reason to make them pay interest at rates charged only to the highest-risk borrowers. If the debtors fail to make their plan payments, their cases will be dismissed or HAFC will obtain stay relief, either of which will reinstate HAFC's contract rates of interest, allow it to pursue its full claims against the debtors, and free it to pursue its normal non-bankruptcy collection remedies,

Besides overlooking bankruptcy's beneficial impact on the debtors' financial conditions, HAFC's witnesses also made assertions that harmed their credibility: (1) Mr. Widner claimed that the interest rates set by the Agreed Formula were below HAFC's cost of funds, but later admitted that he had no personal knowledge about HAFC's cost of funds; and (2) Mr. Batista similarly claimed that the Agreed Formula rates were below Primus's cost of funds, but later admitted that he was not responsible for borrowing money for Primus, that Primus does not set any rate so low as to lose it money, and that several rates on a Primus rate sheet he used were lower than the rates set for these debtors by the Agreed Formula. The Court does not believe that the rates these witnesses asserted their companies would charge the debtors constitute appropriate market rates that the debtors should have to pay through their chapter 13 bankruptcy plans.

The four witnesses called by the Trustee and the debtors all testified about the differing but similar rates that their institutions charge for car loans made in the Topeka area. The historical rate information the witnesses supplied showed that the Agreed Formula rates were tracking their institutions' rates reasonably well when these bankruptcy cases were filed. At the time of trial, the rate the trustee was using was still very close to the rates these four institutions were offering in the market, even though it had apparently been set by the Agreed Formula more than a year earlier. The Court concludes that these institutions' rates reflect a "market rate for similar loans in the region," and establish that the rates set by the Agreed Formula as of the dates these debtors filed for bankruptcy were appropriate market rates for the debtors in these cases to be required to pay.

Besides coinciding with reasonable market rates, the Agreed Formula rate has been fair to both creditors and debtors, has been easy to ascertain, and has generally saved time and money for everyone concerned by limiting the need for litigation over the proper interest rate. While the Agreed Formula arrived at the appropriate interest rate by adding three percent to the T-bill Rate, a method that *Hardzog* said "will probably not accurately reflect the market," 901 F.2d at 860, the evidence presented in these cases showed that the Agreed Formula in fact did accurately reflect the market, and could properly be used in these cases.

For these reasons, the Court concludes that the interest rates set for these cases by the Agreed Formula constitute "market rate[s] for similar loans in the region," as required by *Hardzog*, and establish the interest rates that HAFC is entitled to be paid on its secured claims. HAFC's objections to the debtors' plans are therefore overruled.

The Court notes that the evidence presented in this case demonstrated that the Agreed Formula (the T-bill Rate plus three percent) tracked the market rate for automobile loans in the Topeka, Kansas, area very well while the underlying riskless rate was being established every four weeks. This indicates that a comparable frequently-published, frequently-adjusted riskless rate should be chosen to replace the old base rate. The Court will endeavor to select such a rate in the near future.

IT IS SO ORDERED.

Dated at Topeka, Kansas, this _____ day of January, 2002.

JAMES A. PUSATERI
CHIEF BANKRUPTCY JUDGE